United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

Stipulated

No. 76-4232 **76-4232**

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

WILLIAM M. IVLER and BARBARA IVLER,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly determined that sums received by the taxpayer[1/] from his employer in 1966 and 1967 were ordinary income, and not capital gain.

STATEMENT OF THE CASE

This case involves federal income taxes in the amount of $26,625.57 for the tax year 1966 and $29,677.44 for the tax year 1967. Taxpayer instituted these proceedings in the United States Tax Court for a redetermination of the deficiency determined by the Commissioner. The memorandum findings of fact and opinion of the Tax Court, which are reported at P-H Memo.

1/ William M. Ivler will be referred to as "the taxpayer." Mrs. Ivler is a formal party to the case because she signed their joint federal income tax return.

T.C., par. 76,223, were filed on July 19, 1976. (R. 13-a.)[2/] On July 21, 1976, the Tax Court entered its decision sustaining the Commissioner's determination. (R. 19-a.) On October 18, 1976, taxpayer timely filed a notice of appeal to this Court. (R. 4-a.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The material facts may be stated as follows:

Taxpayer practiced law in the State of New York from 1947 until the summer of 1963. In 1960, taxpayer was retained by the Gevyn Construction Corporation (Gevyn) as its attorney. Gevyn had been organized in 1958 by George and Evelyne Ungar, who owned two-thirds and one-third, respectively, of its outstanding stock. Gevyn was an electing small business corporation within the meaning of Subchapter S of the Internal Revenue Code. By 1963, from one-tenth to one-fifth of taxpayer's gross fees were derived from the Gevyn account. (R. 14-a, 15-a.)

In July of 1963, the Ungars invited taxpayer to assume the vice-presidency of Gevyn. In the following month, taxpayer accepted that offer and retired from the active practive of law. At that time it was agreed that taxpayer's salary was to be fixed at $30,000 annually. It was further agreed that taxpayer would eventually be given a one-third interest in Gevyn. (R. 15-a.)

2/ "R." references are to the separately bound record appendix.

Taxpayer, however, never received any Gevyn stock. Rather, he entered into an agreement[3/] with Gevyn in February, 1966. The agreement provided that he was to receive a cash payment of $160,000 as a bonus, and, for a period of two years from December 1, 1965, a salary of $100,000 annually. Pursuant to that agreement, taxpayer received $266,833.33 in 1966 and $91,666.67 in 1967. (R. 15-a.)

In his 1966 federal income tax return, taxpayer reported $31,000 of the amount he received pursuant to the aforementioned agreement as ordinary income; the balance was reported as long-term capital gain. On the return filed for 1967, $27,500 was reported as ordinary income, and again the balance as long-term capital gain. (R. 15-a.)

3/ The agreement, after reciting that Gevyn agrees to employ Ivler and that Ivler agrees to "devote his entire time" to Gevyn's business, provides (Ex. 3-C, p. 2):

> 3. As consideration for the services rendered to Gevyn prior to the date hereof, for which the Employee was never fully recompensed, Gevyn agrees to pay to the Employee, in cash as a bonus prior to February 15, 1966, a sum of money equal to $160,000.00 (One Hundred and Sixty Thousand Dollars), less normal deductions.
>
> From and after December 1, 1965, Gevyn shall pay the Employee as compensation hereunder the sum of $100 000.00 (One Hundred Thousand Dollars) per annum, pay in monthly installments, on the first day of eac d every month of the term hereof.
>
> 4. The initial term of this Agreement shall be for a period expiring December 1, 1967, and thereafter the Agreement shall be automatically renewed for a term of one year, unless notice of termination is given by either party to the other at least ninety (90) days prior to the end of the then current term.

The Commissioner determined that all sums taxpayer received from Gevyn in 1966 and 1967 represented ordinary income and asserted a deficiency accordingly. The Tax Court sustained the Commissioner's determination on alternative grounds. To begin with, the agreement between Mr. Ivler and Gevyn, pursuant to which the payments in issue had been made, stated that those payments were for a bonus and salary. Such receipts are, of course, properly reportable as ordinary income. Second, even assuming that taxpayer had been able to show that the agreement did not properly describe the payments, there was still no basis for taxing them other than as ordinary income. Rather, no matter whether the payments were made in consideration of Mr. Ivler giving up his practice of law and becoming vice-president of Gevyn or in lieu of stock he was to have received as compensation for his work as vice president, it was, nonetheless, taxable as ordinary income. (R. 16a-18a.)

Taxpayer appeals.

SUMMARY OF ARGUMENT

In early 1966, the taxpayer signed an employment agreement, stating he was to receive $360,000 in the next two years as a bonus and as compensation. The taxpayer received this sum, and reported $60,000 as ordinary income and $300,000 as capital gain, contending that he sold his right to the one-third of the shares of Gevyn to Gevyn for $300,000, and that this sale produced $300,000 of capital gain.

The taxpayer's receipt of the $300,000 was ordinary income. To begin with, these sums were paid pursuant to an employment contract which denominated them as a bonus and as compensation. The taxpayer knowingly signed this agreement. Since the taxpayer did not offer "strong proof" that the agreement was a sham, and that he had a capital asset which he sold, the sums should be treated as ordinary income.

The proof taxpayer introduced in an effort to show that the salary and bonus payments here actually represented consideration for his surrender of claims to Gevyn stock did not, in fact, even show that he had a right to Gevyn stock. Rather, it clearly showed that taxpayer had never reached an agreement with Gevyn and Gevyn's owners as to how or when he would obtain an interest in the business. The evidence introduced paints a picture of parties still in the process of negotiating an agreement, not of parties operating under an agreement already reached. Indeed, the first real sign of a meeting of the minds here is the contract under which taxpayer was paid the sums here in issue. And that contract explicitly characterized the sums here as bonus and salary payments.

In any event, even had taxpayer shown that he had some right to a capital interest in Gevyn, that proof would not have justified taxing the present receipts as anything other than ordinary income. It is clear that whatever rights taxpayer might have received were inextricably tied to his employment, they were no more than a form of in-kind compensation. Had he

actually received stock in Gevyn, then, the value of that stock would have been taxable as ordinary income. His acceptance of cash payments in lieu of his claims to in-kind compensation, does not change the character of the income thus realized. Nor do the cases upon which taxpayer relies justify any different result. Here taxpayer explicitly agreed that the sums in dispute were compensation income. The Tax Court was correct in holding him to his bargain.

ARGUMENT

THE TAX COURT CORRECTLY FOUND THAT ALL OF THE SUMS THAT THE TAXPAYERS RECEIVED FROM GEVYN WERE ORDINARY INCOME

The only issue in this case concerns the question whether all of the approximately $360,000 taxpayer received from his employer, Gevyn, during 1966 and 1967 is taxable to him as ordinary income or whether approximately $300,000 of taxpayer's receipts are taxable at preferential capital gains rates as income derived from the sale of a capital asset. Internal Revenue Code of 1954, Secs. 61, 1221, 1222, Appendix, infra. We submit that the Tax Court was correct in determining that all taxpayer's receipts were taxable as ordinary income.

To begin with, the amounts taxpayer received here were paid him pursuant to an employment contract which clearly characterized all the amounts at issue as either a bonus or as salaries (Ex. 3-C). Such bonuses or salary payments are, quite clearly, taxable as ordinary income. Specifically, the argument provides (Ex. 3-C, p. 2):

> 3. As consideration for the services rendered to Gevyn prior to the date hereof, for which the Employee was never fully recompensed, Gevyn agrees to pay to the Employee, in cash as a bonus prior to February 15, 1966, a sum of money equal to $160,000.00 (One Hundred and Sixty Thousand Dollars), less normal deductions.
>
> From and after December 1, 1965, Gevyn shall pay the Employee as compensation hereunder the sum of $100,000.00 (One Hundred Thousand Dollars) per annum, payable in monthly installments, on the first day of each and every month of the term hereof.

We submit that this agreement, which taxpayer, a lawyer, testified (R. 74-a) he had signed with a full knowledge of its contents, should conclude the present matter. As this Court has

stated, the economic consequences of a contract should be given tax effect in accord with the terms of the contract unless a taxpayer can introduce "strong proof" that the contractual terms do not reflect the tax reality. Estate of Rogers v. Commissioner, 445 F.2d 1020 (C.A. 2, 1971); Ullman v. Commissioner, 264 F.2d 305 (C.A. 2, 1959); see Deshotels v. United States, 450 F.2d 961 (C.A. 5, 1971); cf. Clark v. United States, 341 F.2d 691 (C.A. 9, 1965); Hamlin's Trust v. Commissioner, 209 F.2d 761 (C.A. 10, 1954); and Danielson v. Commissioner, 378 F.2d 771 (C.A. 3, 1967), cert denied 389 U.S. 858 (1967). Or, as the Supreme Court stated in Commissioner v. Nat. Alfalfa Dehydrating, 417 U.S. 134, 149 (1974):

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, Higgins v. Smith, 308 U.S. 473, 477 (1940); Old Mission Portland Cement Co. v. Helvering, 293 U.S. 289, 293 (1934); Gregory v. Helvering, 293 U.S. 465, 469 (1935), and may not enjoy the benefit of some other route he might have chosen to follow but did not. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." Founders General Corp. v Hoey, 300 U.S. 268, 275 (1937); Television Industries, Inc. v. Commissioner, 284 F.2d 322, 325 (C.A. 2 1960); Interlochen Co. v. Commissioner, 232 F.2d 873, 877 (CA4 1956). See Gray v. Powell, 314 U.S. 402, 414 (1941).

The employment agreement taxpayer executed leaves little room to dispute the manner he and Gevyn chose to organize their affairs. They chose to structure the payments here at issue as compensation and compensation only. Nor could the proof

taxpayer introduced to contradict the terms of the contract here be classified as "strong proof" warranting any form of taxation other then that clearly mandated by the contract itself.

Taxpayer, of course, argues that the bonus and salaries provided under the employment contract were, in reality, disguised stock purchase payments. The proof below falls far short of bearing out that claim, however.

Rather, that proof indicates how really far from agreement the Ungars, Gevyn and taxpayer were until they entered the employment agreement which the Tax Court found controlling here. Thus, taxpayer first testified to the effect that his rights to the one-third stock interest in Gevyn vested immediately upon his accepting employment, subject to defeasance should the Ungars exercise a retained right to reclaim the stock (R. 38-a). Later, taxpayer contradicts this testimony by stating that even after the lapse of two years he was still negotiating for the transfer of stock to him. He testified (R. 41-a):

> A. I spoke to George and Evelyn, I quite frankly, this was done on an every day affair of talking about it, but I did mention the fact that nothing had been formalized and his time has come and the two years are up. And there constantly was a question as George and Evelyn brought up that "gee whiz, they didn't know how they were going to do this mechanically and to limit the tax-consequence to them," and I suggested that we go see a former associate of mine, a friend by the name of Jack Alyson, John P. Alyson who is a senior partner of Marshall, Brattor, Alyson --

Still later in his testimony, taxpayer stated (R. 46-a-47-a) that Exhibit 7-G accurately reflected the agreement he had with the Ungars in regard to the stock. But Exhibit 7-G, a memorandum written by Mrs. Ungar to the taxpayer, shows the true state of indecision that existed in regard to the taxpayer's rights to stock. Exhibit 7-G addresses itself at one point to the Ungars selling their stock to the taxpayer for a "small sum" in cash and a note for the balance of the apparently undetermined purchase price. Later, the memorandum discusses allocating a portion of the corporation's profits to taxpayer and having those profits (which were apparently going to be distributed to the Ungars in any event) represent the purchase price for a one-sixth interest. Finally, the memorandum discusses the possibility that the Ungars would bequeath shares of stock to taxpayer. Mrs. Ungar was hardly engaging in understatement when she stated in the memorandum (Ex. 7-G, p. 1) that she was "still confused and for some idiotic reason haven't grasped how it's to happen." The confusing and contradictory versions of the stock transfer plans discussed in the memorandum, a memorandum that taxpayer stated "pretty much reflects what [he and the Ungars] * * * had discussed, agreed to and had understood" (R. 47-a), make it rather clear that there had never been any real agreement between the parties as to the stock taxpayer was to receive or how or when he was to receive it.

The other exhibits introduced at the trial illustrate even further the complete absence of a meeting of the minds between the Ungars and the taxpayer as to taxpayer's possible ownership of Gevyn stock. For example, Exhibit 6-F is a copy of a draft agreement which was never executed by the parties. This agreement is nonetheless instructive in that it would appear that someone contemplated yet another possible means of transferring shares of stock to taxpayer. The author of this document apparently thought Gevyn would issue new shares to the taxpayer; the Ungars would not be surrendering any of their shares. More interestingly, under this proposed contract, however, it appears that taxpayer's "compensation" was set at the greater of $75,000 or 16 2/3 percent of Gevyn's profits per year for the first two years of taxpayer's employment. He was not entitled to receive the full amount of that "compensation" immediately, however. Rather, any amount he earned in excess of a monthly $3,000 "draw" was to be withheld by the corporation to be applied to taxpayer's purchase of Gevyn stock. Significantly, however, taxpayer's full rights in the stock he was thus "purchasing" with withheld compensation were not to vest until he had completed two year's service under the employment agreement. If he failed to complete the two years' employment, he was entitled to receive only the difference between the amounts actually paid him through his "draw" and his total "compensation" of $75,000 per year. This draft agreement, thus, hardly comports with taxpayer's claim

that he was vested with rights in Gevyn stock immediately upon his accepting employment with that corporation.

Nor does the other documentary evidence introduced below support taxpayer's allegation that he became the owner of Gevyn stock or of the right to purchase Gevyn stock when he accepted employment there. Rather, this other evidence is on a par with that previously discussed and simply illustrates how little the parties here had actually agreed to. In both Exhibits 5-E and 9-I, memoranda prepared by attorneys to help the parties here to formalize their purported agreement, the parties' attorneys expressed their inability to understand, much less produce a formal document articulating, the agreement that taxpayer and the Ungars had reached. And the latter of these memoranda was drafted fully two years after taxpayer began to work for Gevyn, two years after the time taxpayer alleges he acquired a stock interest in Gevyn.

While it does seem that taxpayer and the Ungars had reached a preliminary understanding that taxpayer would somehow and in some way acquire a stock interest in Gevyn, the record hardly establishes that he actually had either any present ownership rights in or any vested option to acquire such stock as of the date he entered into the employment agreement here. Absent that proof, taxpayer has no strong evidentiary basis for the major premise of his argument on appeal--that a portion of the amounts paid to him under the employment agreement dated November 30, 1965, constituted payment for such stock or option rights.

Since taxpayer failed to produce "strong proof" that he had any existing rights to stock even to exchange for the money paid to him under that employment contract, the Tax Court was entirely justified in finding that taxpayer's receipts were just what the contract said they were, salary and bonus payments. Estate of Rogers v. Commissioner, supra.

We might note, moreover, that the evidence of record, to the extent that it provides any support at all to taxpayer's theory that he had a right to Gevyn stock, makes it rather clear that taxpayer's rights were given to him as a form of compensation. It seems quite clear that neither taxpayer's employer nor the Ungars proposed to make taxpayer a gift of the stock he contends he was entitled to receive. There is no indication whatsoever that "detached and disinterested generosity" played a part in any of the transactions here or that the transfer of rights to stock, assuming arguendo that there was such a transfer, stemmed from "affection, respect, admiration, charity or like impulses." Commissioner v. Duberstein, 363 U.S. 278, 285 (1959); Commissioner v. LoBue, 351 U.S. 243 (1956); Olk v. United States, 536 F. 2d 876 (C.A. 9, 1976), cert. denied, 45 U.S.L.W. 3326 (November 2, 1976). Rather, it seems clear that whatever rights taxpayer might have been entitled to receive in Gevyn were tied inextricably with his employment and constituted nothing more than another form of compensation. Commissioner v. LoBue, supra; United States v. Frazell, 335 F. 2d 487 (C.A. 5, 1964), cert. denied, 380 U.S. 961 (1965); Champion v. Commissioner, 303 F. 2d

837 (C.A. 5, 1962); Commissioner v. Vandeveer, 114 F. 2d 719 (C.A. 6, 1940); James v. Commissioner, 52 T.C. 63 (1969); Beals' Estate v. Commissioner, 82 F. 2d 268 (C.A. 2, 1936); Batterman v. Commissioner, par. 43097, P-H Memo. T.C., aff'd, 142 F. 2d 448 (C.A. 6, 1944); Ingram v. Commissioner, par. 5320, P-H Memo T.C.; Wolden v. Commissioner, 493 F. 2d 608 (C.A. 2, 1974); Treasury Regulations on Income Tax (1954 Code), § 1.61-2 (26 C.F.R.).[4/]

Taxpayer's "exchange" of such rights to compensation, rights which had never been included in his income, for cash consideration would not qualify for capital gain taxation in any event. Hort v. Commissioner, 313 U.S. 28 (1941); Gordon v. Commissioner, 29 T.C. 510 (1957), aff'd, 262 F. 2d 413 (C.A. 5, 1958); Shuster v. Helvering, 121 F. 2d 643 (C.A. 2, 1941); Seserman v. Commissioner, par. 62191 P-H Memo. T.C.; Roscoe v. Commissioner, par. 53181 P-H Memo. T.C., aff'd, 215 F. 2d 478 (C.A. 5, 1954).

Nor do the cases upon which taxpayer relies indicate otherwise. In both Dorman v. United States, 296 F. 2d 27 (C.A. 9, 1961) and Turzillo v. Commissioner, 346 F. 2d 884 (C.A. 6, 1965),

4/ The fact that under some of the plans discussed by the Ungars and taxpayer, the Ungars rather than taxpayer's employer, Gevyn, were to transfer the stock to taxpayer does not alter this conclusion. The value of property transferred to a taxpayer by someone other than a taxpayer's employer, but on account of the taxpayer's employment, is taxable as ordinary income. Van Dusen v. Commissioner, 166 F. 2d 647 (C.A. 9, 1948); Kane v. Commissioner, 25 T.C. 1112 (1956), aff'd, 238 F. 2d 624 (C.A. 2, 1956).

the taxpayers had acquired ownership or rights to acquire ownership of capital interests in businesses through investment.[5/] Thereafter, in both of those cases, the taxpayers had had a falling out with their fellow investors and, in the end, terminated all relations with their former businesses. Each received consideration for release of all claims they had against and to those businesses and each actually surrendered all stock and options they held in those businesses. In each case, in turn, the taxpayers were held entitled to treat a portion of the consideration they received as capital gain income. The taxpayers in Dorman and Turzillo, then, unquestionably held interests or fixed rights to acquire interests in the businesses there, those interests or rights were the product of the taxpayers' investments and those interests and rights were explicitly conveyed in consideration of the sums held entitled to treatment as capital gain income. The same can hardly be said of taxpayer's situation. It is by no means clear that he had anything more than an expectancy interest in Gevyn. Whatever interest he might have been entitled to receive would not have been the product of his investment, but rather a product of his employment, merely another form of compensation. And, finally, the amounts taxpayer here seeks to have treated as capital gain income were paid to him under a contract that explicitly characterizes the payments as compensation, rather than consideration

5/ In Dorman, supra, the taxpayer had borrowed funds from his partner to acquire an interest in the partnership they intended to form.

for property. Dorman and Turzillo simply do not cover taxpayer's situation.

Taxpayer's receipts are, we submit, best taxed as he and his payor implicitly agreed they should be taxed, as compensation income. Taxpayer has introduced no strong proof to justify taxing the payments in a manner inconsistent with the contract. Indeed, the evidence introduced in support of preferential capital gain taxation, to the extent that it shows any form of agreement to transfer stock to taxpayer, shows generally that taxpayer's rights to that property were no more than rights to receive in-kind compensation. His acceptance of cash in exchange for a claim to such in-kind compensation would not qualify for capital gain taxation in any event. In sum, there is no basis for treating the amounts explicitly characterized as compensation as anything other than that, compensation.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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JANUARY, 1977.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 17th day of January, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * *

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or a memorandum, or similar property, held by--

(A) a taxpayer whose personal efforts created such property.

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange,

in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B):

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any or its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

* * *

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *